



MICHAEL J. MURPHY
State Treasurer

The QUARTERLY

Local Government Investment Pool

Fourth Quarter 2005

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Bernanke handed clean slate to shape monetary policy

Retiring Fed Chairman Alan Greenspan handed the baton to his successor Ben Bernanke during the last Federal Open Market Committee (FOMC) meeting, which saw the Fed raising federal funds rate by another 25 basis points to 4.5 percent. This is the 14th consecutive Fed hike. The Fed statement included a key phrase that provides a direction to its monetary policy, saying it “may need some further policy firming to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance.”

Fed members also unanimously dropped the word “measured,” giving Bernanke a free rein to devise his own monetary policies vis-à-vis U.S. economic momentum.

What can we surmise from the latest FOMC meeting? The most noticeable message was its observation that economic data have been uneven despite economic growth remaining solid and core inflation very low. Two factors the Fed might be watching closely are increases in resource utilization and elevated energy prices that could potentially increase inflation pressures.

The market sees a higher probability that March fed funds could move by another 25 basis points at the time of this writing. The flow of economic data from now until the next Fed meeting will give investors a clearer picture of how the Fed will react. Bernanke’s mettle will be tested if and when inflation pressures rise to a level that the Fed might not be able to tolerate.

Monetary policy under Greenspan

Alan Greenspan has brilliantly orchestrated the course of U.S. monetary policy for 18 years, yielding enormous successes in fostering economic growth and maintaining price stability. Under the maestro’s tenure, the U.S. economy has weathered numerous economic imbalances that have been neutralized and contained by the brilliant machinations of the Fed’s monetary policy adjustments. Although Greenspan’s rhetoric was always a challenge to investors, he was successful in transmitting the essential gist of his policies. The subsequent result of a reliable U.S. monetary policy was the economy’s ability to correct imbalances in a shorter time period. U.S. economic recessions have been shorter in recent memory, and economic growth has tended to be more resilient in the face of global turmoil. Greenspan is a tough act to follow, but his equally talented successor Bernanke has vowed to continue the Federal Reserve’s twin goals of fostering economic growth and price stability.

Bernanke’s bias

The only marked departure of the “Bernanke Fed” from Greenspan’s is his bias toward inflation-targeting. According to Bernanke:

“... the central bank must maintain a strong commitment to keeping inflation--and, hence, public expectations of inflation--firmly under control (the “constrained” part of constrained

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Market summary from page 1

discretion). Because monetary policy influences inflation with a lag, keeping inflation under control may require the central bank to anticipate future movements in inflation and move preemptively. Hence constrained discretion is an inherently forward-looking policy approach."

This statement by the new Fed chairman illustrates that his policy framework will place a strong emphasis on maintaining a low and stable inflation that, if successful, will translate to better economic efficiency.

Well-anchored inflation expectations make the Fed's job much easier as a stable and balanced output and employment promote a more steady economic growth in the long-run and it also lowers the inflation risk premium. A case in point is the US economy which has shown incredible resilience in 2005, with GDP growing at a 3.5% rate, despite oil prices going up and a major natural disaster like hurricane Katrina. The US economy continued to have a manageable inflation expectation brought about by the Fed's ability to orchestrate a flexible monetary policy. The Fed's inflation expectation with PCE deflator as a gauge is around 1.90-2.00 percent and the core CPI index (consensus) is estimated to be around 2.00-2.3 percent.

The U.S. economy's uneven growth

Economic growth has been uneven over the last year but still above the level expected by most economists. The continuous rise in interest rates has somewhat dampened the real estate market and consumer spending, which have been sectors that sustained economic momentum during the past few years. However, strong profitability in the corporate sector has led to solid trends in business capital investment and hiring. Capital investment growth compensated for the relatively

weak private sector consumption.

Real interest rates were influenced by global distortions affecting the US economy. The global savings glut, for example, has allowed the U.S. economy to maintain relatively low interest rates as foreigners continue to use U.S. assets as part of core holdings to manage their respective economies. Foreign investors continued to buy U.S. bonds, not only to support their currencies but to recycle excess dollars to maintain economic equilibrium.

Oil money and the Asian export machinery fueled bond buying, which contributed to the flattening of the yield curve. It also highlighted the fact that, despite the Fed's continuous rate hikes, the economy was still accommodative in early 2005 and the perceived low inflation risk premium in the U.S. bond market made foreign investors dominant players. The slowdown was just evident during the last quarter of 2005 when the effects of higher interest rates dramatically slowed home equity extraction, thereby slowing consumption.

The U.S. corporate sector, on the other hand, has kept large cash holdings due to concerns that the economy could lose its momentum. The sustained profitability in 2005 has emboldened U.S. companies to rebuild their existing capacity as utilization rates hovered above 80 percent. Employment has also manifested signs of solid gains as non-farm payrolls rose to unexpected levels, pushing the unemployment rate below 5 percent.

The U.S. economic outlook for 2006 remains robust despite elevated energy prices and slowing corporate profits. This scenario fits into the Fed's goal of maintaining growth and price stability. GDP consensus forecast for 2006 is around 3 to 3.5 percent, keeping its above-trend potential, assuming the rate hike cycle is nearing its neutral rate.

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Market summary

continued

The last quarter of 2005 resulted in a 23.3 percent increase in the production of business equipment and a 14.9 percent increase in non-defense capital goods equipment. Economists are expecting business spending momentum to continue, in light of higher capacity utilization rates.

Investors' main concern is if the economy will achieve a soft landing in the property market and consumption. Housing figures suggest that 14 consecutive rate hikes have dented investors' appetite. December sales of previously owned homes have plummeted 5.7 percent to the lowest level since March 2004. Thirty-year mortgage rates have gone up to levels between 6.25 and 6.5 percent, which could make it difficult for prospective home buyers and existing homeowners to lock-in or refinance mortgages.

As mentioned, consumption should be closely monitored as well, because higher rates and home equity extraction are current negative factors that could dampen personal spending. Moreover, a negative savings rate of -0.5 percent for 2005 does not alleviate consumers' plight. At this juncture, due to the "unevenness" of economic growth, the Fed can only monitor developing events before they taking action.

U.S. rates review and outlook

The yield curve has flattened and inversion has persisted in the 2-3 year and 2-5 year areas. The market has continued to factor in subsequent rate hikes in the short end of the curve. However, many market players are also speculating about the possibility of a pause, with some even calling for an ease by the end of the year.

The two-year notes efficiently re-priced succeeding rate hikes as its yield rose to as high as 4.59 percent. The longer-term interest rate on 10-year bonds also had yields between 4.5 and 4.57 percent. The latest

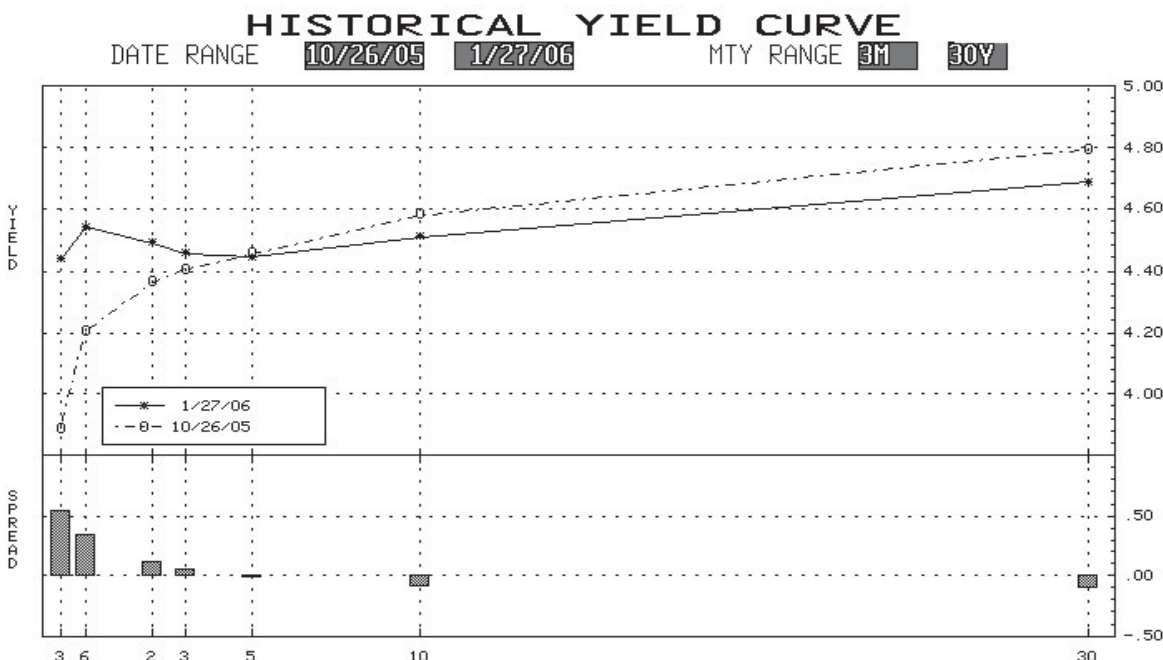
rate hike saw the yield curve inverted again for the second time since December. Investors focused on employing flatteners and steepeners, depending on economic data and outlook. Range trading dominated the market as a whole. The GSEs continued their issuance in the 2-, 3-, and 10-year areas and received well-supported participation as spreads tightened versus treasuries and swaps.

Volatility has stayed almost stagnant during the last quarter of 2005 and January 2006. Callables that had been a staple for most investors saw a marked decline in purchases in the short-end. Most investors preferred selling volatility in the longer part of the curve as rates were more attractive. Duration-sensitive accounts preferred callables as extensions on a flat or inverted yield curve made bullet papers unattractive. The belly of the curve continued to be the most expensive part of the curve during the same period. Investors are expecting that 2006 will trade in a range-bound environment. The Fed expressed its intention to tie its rate moves to economic data, as Bernanke's main concern is quelling inflation.

The LGIP

The LGIP yields continue go up each month, as the Fed continues its tightening ways. The fed funds rate has been raised by 25 bps at 14 consecutive meetings, bringing the rate to 4.50 percent. The Fed is widely expected to raise the rate again by 25 bp at the March 28 FOMC meeting. In anticipation of rising rates the average life of the LGIP portfolio has been kept around 30 days to be able to reprice to the rising funds rate as quickly as possible.

Accordingly, the net LGIP yield increased from 3.76 percent to 3.96 percent and then to 4.16 percent during October, November and December, respectively. LGIP participants should expect the LGIP yields to continue to rise as long as the Fed continues to raise the fed funds rate.



From the LGIP Administrator's Desk:

By Robbi Stedman

Happy 2006! Can you believe it's February already? The change of the year often brings staff changes and newly elected officials for many of you. We've had a few experiences recently where a participant has called in to make a transaction only to find that it can't happen because they are not authorized. Furthermore, everybody who is authorized on their account no longer works there. What happens then? Unfortunately, the transaction can't happen until we have an updated form. This brings me to an important reminder to keep your account updated whenever personnel changes occur. If you don't know who is authorized on the account, please give me a call and I can look it up on our system. If you use TM\$, just select "Participant Information" to see who is on your account. You can find these forms on our website at: www.tre.wa.gov. Once you are on our homepage, select the option that says "LGIP" and scroll to the bottom of the page. Here you will find "Forms Needed to Join the Local Government Investment Pool." The first is the Transaction Authorization Form, which replaces any previous form. This one you will want to make sure that you fill out completely with all of your information. People listed on this form will be the only ones able to make transactions. If you use TM\$ you will need to fill out the second form which is the Treasury Management Log-On Authorization Form. On this form you can add, update, or delete anybody from your account. Once you have filled out the forms you can fax them back to the number indicated on the form if a change is immediately needed and then mail back the originals or just mail the originals. If you have any questions regarding these forms please give me a call.

Treasurer Murphy appoints Union Bank of California as new statewide custody provider

State Treasurer Michael J. Murphy, based on the unanimous recommendation of the RFP Evaluation Team and the LGIP Advisory Committee, appointed Union Bank of California (UBOC) as the new statewide custody provider.

The purpose of the statewide custody program is to ensure the best service for the lowest possible price. It benefits municipalities in a number of ways. First, it allows statewide beneficiaries to forego the RFP and negotiation processes. Because it is a statewide contract, all municipalities are eligible. Second, it introduces a uniform fee schedule, allowing both larger and smaller entities to benefit from lower fees. Although participation is not mandatory, the program offers a viable option with the assurance of a lower fee schedule, a focus on service, and strong contract language.

As was the case in the inaugural search for a statewide custody provider in 1999, the active involvement of local governments was critical in the success of the selection process. The evaluation team consisted of five individuals from around the state: **Carrie Lewellen**, City of Vancouver; **Shelley Pearson**, Kitsap County; **Karen Thomas**, Whatcom County; **Kelley Wood**, City of Redmond; and **Katie Jungquist**, Skagit County Treasurer.

"The committee tried to represent all the potential users of the statewide custody contract. We were trying to match the highest level of customer service and fiscal integrity with an accessible fee structure. I think we achieved that," said Shelley Pearson.

Being a member of the evaluation team meant a significant time commitment that began in October and culminated in the unanimous recommendation that UBOC be appointed as the new Statewide Custody Provider.

"The Team's role in selecting a statewide custody provider ... will provide an invaluable service to the taxpayers of our state by minimizing costs while ensuring the highest level of service possible. Each member of the Team showed much

commitment to make sure that the provider chosen would benefit municipalities throughout the State of Washington," said Treasurer Jungquist.

In addition to the evaluation team, there was a review team that reviewed all RFP documents before they were released. This team included **Tim Jensen**, City of Yakima; **Ross Baglien**, Spokane County; **Zemed Yitref**, City of Bellevue; **Debbie Litchfield**, Chelan Co. PUD; **Mark Wyman**, Thurston County; and **Lori Pearce**, Clark County

Treasurer Murphy expressed his appreciation for the people that had a role in the process, in particular the evaluation team and review teams and involved OST staff.

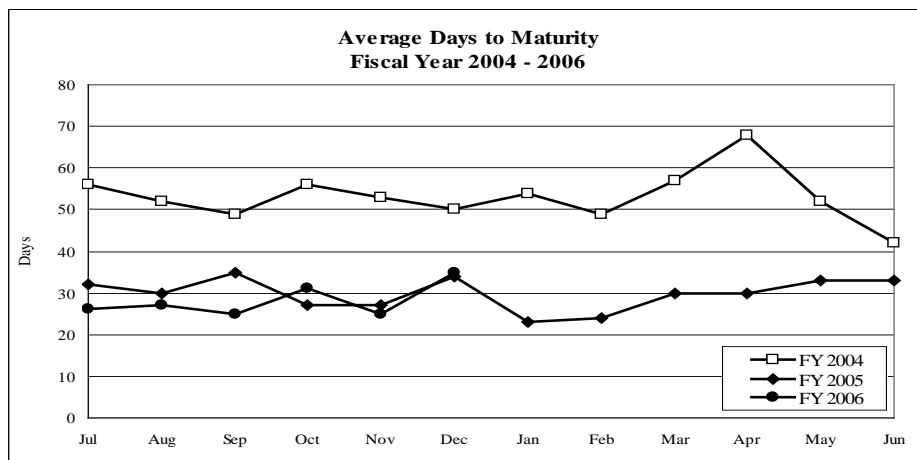
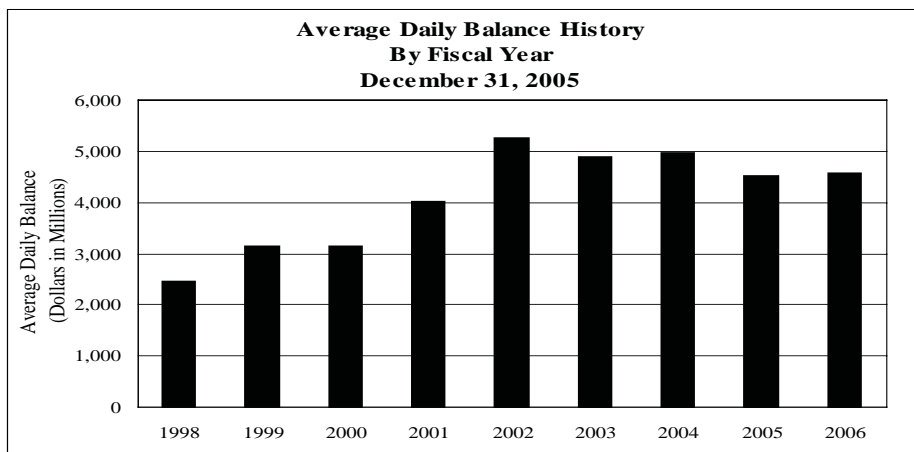
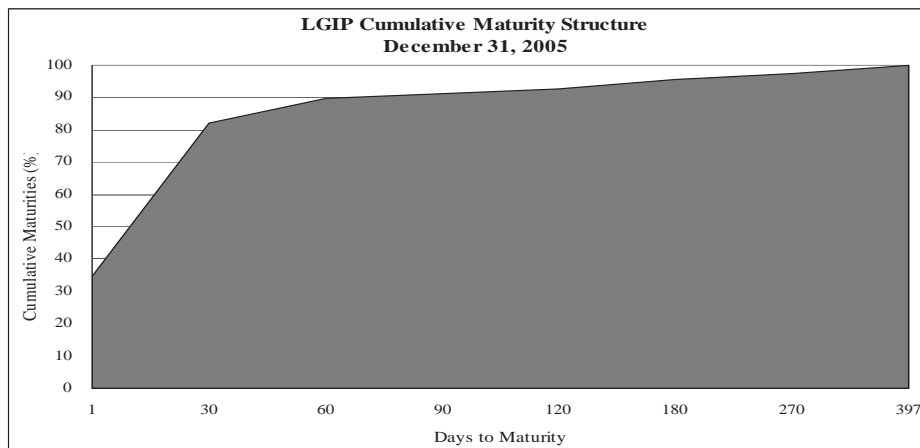
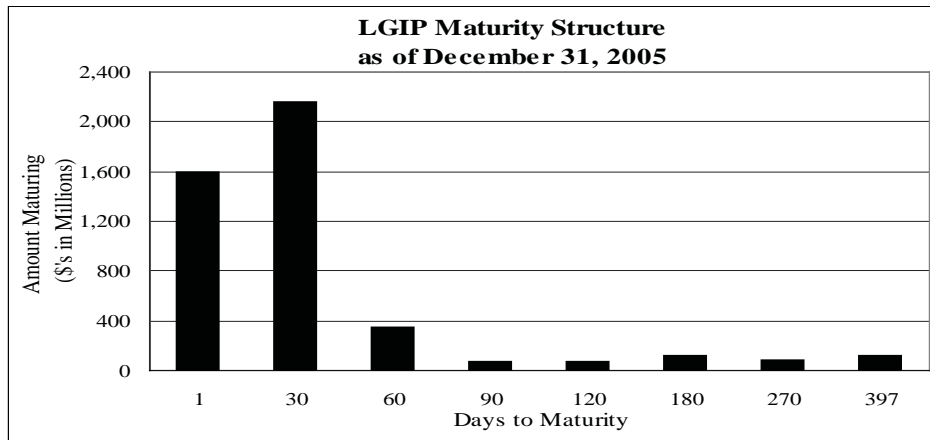
"This was an excellent example of the partnership between my office and local governments as we strive to bring the best possible service to the citizens of Washington," Murphy said.

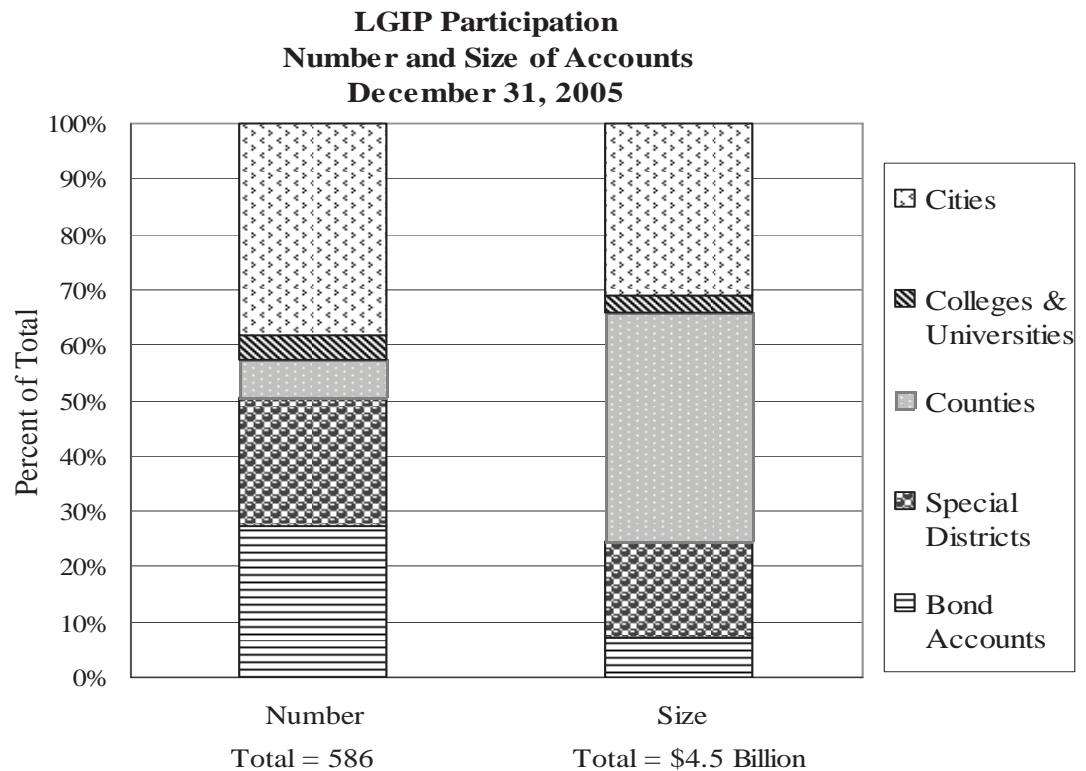
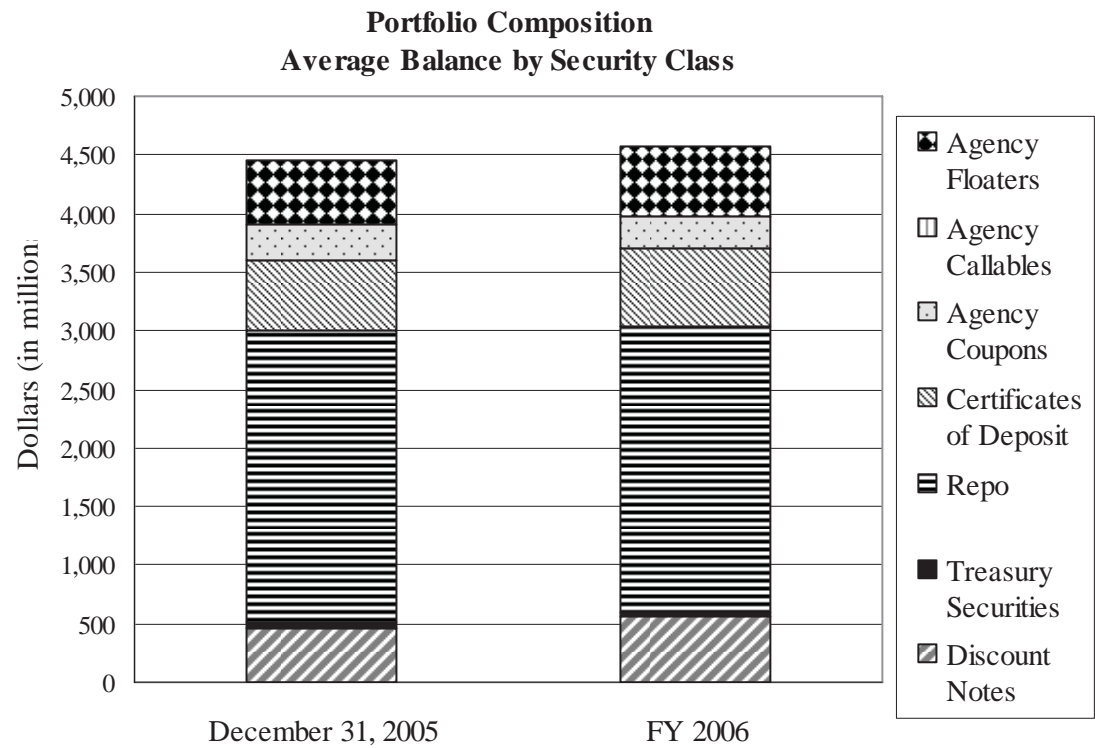
The appointment of UBOC as the statewide custody provider begins April 1, 2006, and is effective until March 31, 2010, with a possible two-year extension.

"We look forward to serving as custodian for the statewide securities custody program sponsored by the state of Washington," said Union Bank of California Executive Vice President Piet Westerbeek, head of the bank's institutional services and asset management division. "Our bank has a long history of serving public institutions in the state, and we are honored to be entrusted with the important task of helping to safeguard their financial assets."

Anyone interested in program details can contact Andy Jeremi, UBOC Vice President for the Statewide Securities Custody Program, at 425-296-6435 or by e-mail at andy.jeremi@UBOC.com.

Information about the program is also available from OST by visiting our web site at (www.tre.wa.gov) or by contacting Doug Extine at 360-902-9012 or by e-mail at doug@tre.wa.gov.





LGIP Advisory Committee: January 30 meeting highlights

The LGIP Advisory Committee meeting was held Monday, January 30, 2006, at noon in the Office of the State Treasurer, General Administration Building, Olympia, Washington.

Treasurer Murphy welcomed Mary Nelson of the Port of Grays Harbor as a new member of the advisory committee, replacing Lynn Hills as a representative of the Washington Public Ports. Mary will finish the remainder of Lynn's term, which expires on April 30, 2006.

Treasurer Murphy welcomed the statewide custody provider evaluation team to the meeting. Doug Extine summarized the 1999-2000 search and explained how the 2005 search was conducted in similar fashion, with significant involvement from local governments. Karen Thomas stated that the evaluation team met before the advisory meeting and unanimously voted to recommend Union Bank of California as the statewide securities custody service provider. A short discussion followed. The committee moved to adopt the recommendation of the evaluation team. The motion was unanimously accepted.

Doug gave an update on the performance of the LGIP. The net rates for the Pool for October, November, and December were 3.76, 3.96 and 4.16 percent, respectively. Since the Advisory Committee last met in late October, the fed funds rate has gone up 25 basis points (bp) at each FOMC meeting, i.e., November 1 and December 13, and is widely expected to be increased again at the January 31 FOMC meeting.

Doug spoke about the strategy for managing the LGIP portfolio. Currently, the portfolio has an average life of 33 days and the anticipated gross yield of the LGIP should be above 4.40 percent for February. As has been the case for the past several months, the strategy

is to keep short in anticipation of continued fed fund increases. Discussion followed.

An update was provided of FY 2006 budget utilizing a handout provided to committee members. The original estimate of fees and overdraft charges was \$1,403,000 which is based on an average daily balance of 4 billion. With estimated expenses of \$581,000 the anticipated rebate was \$822,000. Based on six months of actual fees and expenses, where fees collected were higher than estimates while expenses were lower than estimates, the estimated rebate of is now \$130,000 higher, at \$952,000.

Robbi distributed a handout to committee members describing LGIP month-end balance activity for FY 2004, 2005, and 2006. She explained that balances are comparable to what they were in FY 04 and 05. Another handout portrayed the daily balances from the second quarter of 2006. The balance in the Pool is currently at \$4.5 billion.

Robbi gave an update on the migration to Bank of America's internet-based BA Direct. Since the last meeting Bank of America assisted OST with the set-up of the LGIP repetitive wire templates. OST staff are now familiarizing themselves with BA Direct. Discussion followed.

The Evaluation Team provided feedback to the LGIP Advisory Committee on a successful due diligence trip to New York to examine The Bank of New York's operations as custody provider and lending agent for the LGIP.

The next meeting will be scheduled in April 2006. When that date has been selected, committee members will be notified.

The meeting was adjourned at 1:40 p.m.

GASB 40 and the LGIP

OST has received numerous inquiries from LGIP participants on how to treat their LGIP balances with regards to GASB 40. In anticipation of those inquiries OST has worked with Peterson Sullivan, the independent firm that audits the LGIP, to develop an example of language that may be used in your annual reports. The following represents an example of what LGIP participants could say regarding GASB 40 and their LGIP balances:

The LGIP is an un-rated 2a-7 like pool, as defined by GASB 31. Accordingly, participants' balances in the LGIP are not subject to interest rate risk, as the weighted average maturity of the portfolio will not exceed 90 days. Per GASB 40 guidelines the balances are also not subject to custodial credit risk. The credit risk of the LGIP is limited as most investments are either obligations of the US government, government sponsored enterprises, or insured demand deposit accounts and certificates of deposit. Investments or deposits held by the LGIP are all classified as category 1 risk level investments. They are either insured or held by a third-party custody provider in the LGIP's name.

**Washington State Local Government Investment Pool
Position and Compliance Report
as of 12/31/2005
(Settlement Date Basis)**

In Thousands

LGIP Portfolio Holdings

	Amortized Cost	Percentage of Portfolio
Agency Bullets	\$ 374,022	8.17
Agency Discount Notes	142,270	3.11
Agency Floating Rate Notes	553,931	12.10
Certificate of Deposit	176,250	3.85
Interest Bearing Bank Deposits	553,800	12.10
Repurchase Agreements	2,777,178	60.67
U.S. Treasury Bills	0	0.00
U.S. Treasury Coupons	0	0.00
	\$ 4,577,451	100.00

Securities Lending Holdings

Repurchase Agreements \$ 5,500

Total Investments &

Certificates of Deposit \$ 4,582,951

Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

	Holdings	Percentage of Portfolio	Policy Limitations Percentage
Floating Rate and Variable Rate Notes	\$ 621,098	13.49%	30%
Variable Rate Notes > 397 Days	0	0.00	10%
Other Structured Notes	0	0.00	10%
Term Repo > 30 Days	0	0.00	30%
Certificate of Deposit	132,250	2.87	10%
Bankers' Acceptances	0	0.00	20%
Commercial Paper	0	0.00	25%
Reverse Repo	0	0.00	30%
Security Lending + Reverse Repo	26,956	0.59	30%

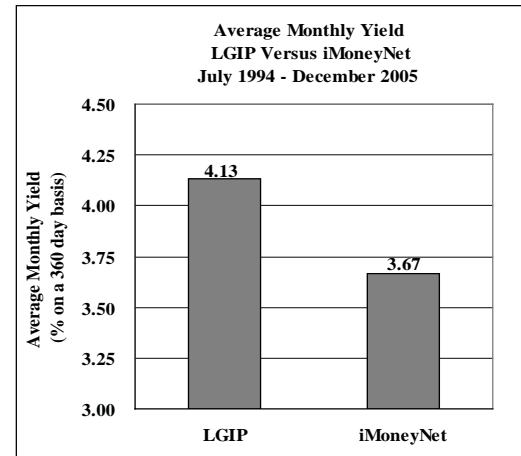
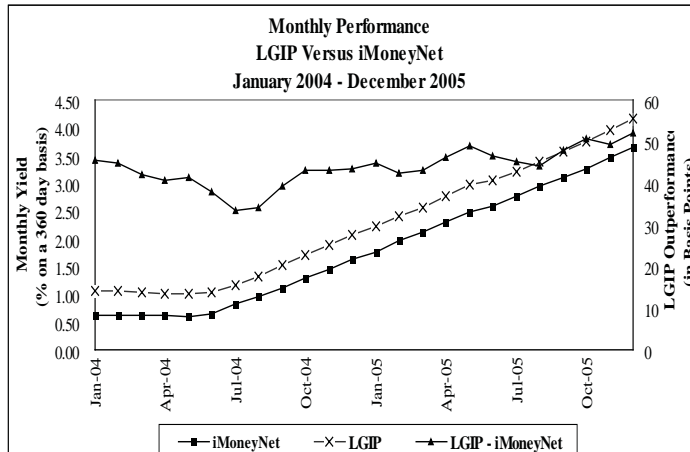
Maturity Limitations

	Currently	Policy Limitations
Weighted Average Maturity	35 day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	381 day(s)	397 day(s)
Floating Rate and Variable Rate Notes	412 day(s)	762 day(s)
Repos	30 day(s)	180 day(s)
Reverse Repos	0 day(s)	90 day(s)

Repo Limits Per Dealer

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LGIP Performance Comparison iMoneyNet, Inc.¹ versus Local Government Investment Pool



The chart on the left shows a monthly comparison from January 2004 through December 2005 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to December 2005. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.5 basis points. This translates into the LGIP earning \$187.05 million over what the average comparable private money fund would have generated.

¹ Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, *Money Market Insight*, iMoneyNet, Inc., West borough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Position and Compliance Report as of 12/31/05 from page 9

Repo Limits Per Dealer

	September 30, 2005	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 10/03/2005	Projected Position 10/03/2005
Banc America Securities	\$ 290,000	6.34%	4.37%	\$ 90,000	\$ 200,000
Bear Stearns & Co.	505,500	11.04%	8.74%	105,500	400,000
Greenwich Capital	375,000	8.19%	8.19%	0	375,000
Lehman Brothers Inc.	72,178	1.58%	0.00%	72,178	0
Merrill Lynch	890,000	19.44%	8.74%	490,000	400,000
Mizuho Securities	250,000	5.46%	5.46%	250,000	
Morgan Stanley Dean Witt	<u>400,000</u>	8.74%	8.74%	<u>0</u>	<u>400,000</u>
Total	\$2,782,678			\$757,678	\$2,025,000

Local Government Investment Pool
STATEMENT OF NET ASSETS
December 31, 2005
(in Thousands)

Assets

Investments, at Amortized Cost:	
Repurchase Agreements	\$ 2,777,178
U.S. Agency Securities	1,070,222
Total Excluding Securities Lending	<u>3,847,400</u>
Securities Lending Investments, at amortized cost:	
Repurchase Agreements	5,500
Total Investments (Settlement Date Basis)	<u>3,852,900</u>
Due to Brokers - Securities Sold But Not Settled, at Amortized Cost:	
U.S. Agency Securities	(34,135)
Total Investments (Trade Date Basis)	<u>3,818,765</u>
Interest Bearing Bank Deposits	553,800
Certificates of Deposit	176,250
Cash	4,913
Interest Receivable	12,377
Investment Maturities Pending Receivable	34,144
Total Other Assets	<u>781,484</u>
Total Assets	<u>4,600,249</u>

Liabilities

Accrued Expenses	168
Obligations under Securities Lending Agreement	5,500
Total Liabilities	<u>5,668</u>

Net Assets

	<u>\$ 4,594,581</u>
Total Amortized Cost - Settlement Date Basis	\$ 4,582,950

QUARTER AT A GLANCE
October 1, 2005 to December 31, 2005
(in Thousands)

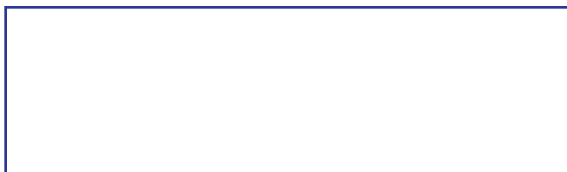
Total investment purchases:	\$ 48,338,246
Total investment sales:	\$ 1,428,054
Total investment maturities:	\$ 46,985,246
Total net income:	\$ 47,760
Net of realized gains and losses:	\$ 82
Net Portfolio yield (360-day basis):	
	October 3.7576%
	November 3.9627%
	December 4.1605%
Average weighted days to maturity:	35 days



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